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IN THE

Supreme Court of the United States

October Term, 1965
No. 466

OIL BASE, INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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COMMISSIONER OF INTERNAL REVENUE,

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Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Petitioner prays that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Ninth Circuit entered on May 23, 1966. This judgment affirmed a decision of the Tax Court of the United States which had in part sustained a determination by the Commissioner of Internal Revenue, the respondent herein, that there was a deficiency in the petitioner's federal income tax liability for its fiscal year ended September 30, 1959.

The Decision, Judgment and Opinions Below.

The decision of the Tax Court involved in this proceeding was entered on January 12, 1965, and the Memorandum of Findings of Fact and Opinion, filed November 17, 1964, while not officially reported, may be found at 23 TCM 1838. The judgment and Opinion of the Court of Appeals was entered May 23, 1966, and the Opinion is reported at .... F. 2d .....

Jurisdiction.

The judgment of the Court of Appeals for the Ninth Circuit is dated and was entered on May 23, 1966. No Petition for a Rehearing was filed. The jurisdiction of this Court is invoked under 28 U.S.C. §1254-(1).

Questions Presented.

1. In reallocating items of income, deduction, etc., under section 482 of the Internal Revenue Code of 1954, is the standard to be applied in every case that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer?

2. May the Commissioner of the Internal Revenue exercise the power conferred upon him by section 482 of the Internal Revenue Code of 1954 in such a manner as to create a loss in one of the controlled taxpayers?

Statute Involved.

The governing statute involved in this proceeding is section 482 of the Internal Revenue Code of 1954, 26 U.S.C. §482, which reads as follows:

> "SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or

allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

Statement.

The petitioner is a California corporation with its principal place of business at 3625 Southwest Freeway, Houston 27, Texas. During the taxable year involved in this proceeding the petitioner's principal place of business was at 130 Oris Street, Compton, California, and its income tax return for the fiscal year ended September 30, 1959, which is the only year involved in this proceeding, was filed with the District Director of Internal Revenue at Los Angeles, California.

Since approximately 1941 the petitioner and its predecessor companies have been engaged in the business of manufacturing and selling oil base drilling fluid and related products to the oil drilling industries. Its principal product is an oil base drilling fluid known as "Black Magic". This is a specialized product in the oil drilling industry possessing qualities and characteristics not found in conventional water base drilling fluids which produce desirable results in oil well drilling and particularly in certain specialized oil well drilling situations.

Despite the desirable results achieved by the use of petitioner's product, it is difficult to sell because it is expensive, dirty, and disagreeable to work with, and therefore the petitioner's selling effort is directed at

all levels of oil well drilling personnel ranging from the top production executives down to the drilling crews.

Since approximately 1946 the petitioner has been selling its products abroad in certain foreign countries where oil drilling activity was being conducted. Prior to October 1, 1955, petitioner's foreign sales had been accomplished through various independent sales representatives.

On or about October 1, 1955, petitioner and Baritina de Venezuela, S. A., a Venezuelan corporation of Caracas, Venezuela, which corporation was unrelated to petitioner, executed an agreement, pursuant to which Baritina was to act the exclusive sales representative for petitioner's products in the country of Venezuela. On or about December 1, 1955, petitioner and Baritina executed a document entitled "Supplemental Agreement," pursuant to which the country of Colombia was added to the territory for which Baritina was to be the exclusive representative of petitioner's products, and further that A Z Export, S.A., a corporation, was named as the exclusive sub-agent and distributor of petitioner's products in the Republic of Colombia.

The agreement between petitioner and Baritina provided a schedule of commissions to be paid and discounts to be allowed by the petitioner to Baritina with respect to the sale of the various products of the petitioner. The rates of commission and discount varied with respect to the several products involved, but generally speaking ranged from fifteen per cent (15%) to twenty-five per cent (25%).

The sales representation agreement between petitioner and Baritina terminated on September 30, 1957.

After such termination the petitioner and Baritina negotiated for the renewal and modification of the sales representation agreement. This negotiation consisted of correspondence between petitioner's management and Baritina's management, and one personal conference between executives of the petitioner and a representative of Baritina. The negotiation also took place in the light of the fact that National Lead Company, which among other things operated a so-called Baroid division, which was a direct competitor of petitioner, had acquired forty per cent (40%) of the stock ownership of Baritina. In the negotiation Baritina demanded an increase in the rates of commission and discount, and further represented to the petitioner that it had just about been breaking even with respect to its representation of the petitioner.

These negotiations resulted in what petitioner's management believed to be an agreement with respect to a new contract, and the petitioner had its attorney prepare a proposed contract embodying the terms of the new agreement. Shortly thereafter, however, certain further correspondence took place between petitioner and Baritina in which Baritina stated that it could not agree with certain of the provisions of the proposed contract. The petitioner would not agree to the elimination of these provisions, and thereafter in April of 1958 negotiations between the petitioner and Baritina were completely terminated.

After these negotiations were terminated, the petitioner's management for some time considered the question of how it was going to continue to market its products in foreign countries. After consulting both their regular corporate counsel in Los Angeles, Cali-

fornia, and a Venezuelan attorney, the petitioner's Board of Directors decided to form a wholly owned Venezuela corporation which would act as the petitioner's sales representatives in foreign countries. Accordingly, on or about June 13, 1958, petitioner caused the formation of Oil Base de Venezuela, C.A., a Venezuelan corporation, as a wholly owned subsidiary of the petitioner.

Thereafter, on or about June 20, 1958, petitioner and Oil Base de Venezuela executed an agreement pursuant to which Oil Base de Venezuela was to act as the petitioner's exclusive sales representative for the sale of petitioner's products in all countries of the world, excluding therefrom all of the states of the United States of America and all of the Provinces of the Dominion of Canada.

This sales representation agreement between petitioner and Oil Base de Venezuela provided for rates of commission and discount in essence as follows: Twenty per cent (20%) of the net invoice billings of sales, exclusive of transportation, packaging, insurance and taxes of those products of petitioner known as O. B. Wate, Filter Presses, Additive "V", O. B. Zero, Mixfix, Additive "X", and Additive "E", and forty percent (40%) of the net invoice billings of sales exclusive of transportation, insurance, packaging, and taxes of all other of the petitioner's products.

Such exclusive representation agreement between petitioner and Oil Base de Venezuela was for a period commencing June 20, 1958, and ending January 1, 1959, but such agreement was extended for an additional year to and including the 31st day of December, 1959, and was further eventually extended to include the calendar years 1960, 1961, and 1962.

In establishing the rates of commission and discount which would be paid or allowed to Oil Base de Venezuela as its exclusive sales representative, the petitioner, through its Board of Directors, considered the following factors:

1. That Baritina had represented to petitioner that it had just about been breaking even on its representation of the petitioner,

2. That Oil Base de Venezuela would be selling solely the products of the petitioner, whereas Baritina represented the products of several manufacturers, and, consequently, had a broader base over which to spread its overhead costs,

3. That Oil Base de Venezuela would be a starting concern without experience, whereas Baritina was and had been an established and going concern,

4. The various manufacturing costs of the products involved, the gross profit involved in the sale of such products based upon such known manufacturing costs and the known selling prices of the products,

5. The high cost of operating in Venezuela and Colombia known to the petitioner's management from information furnished to the petitioner by Baritina, and

6. That it would be necessary for Oil Base de Venezuela to appoint subagents or distributors in various foreign countries and to pay them commissions on sales made in those countries.

During the year in question Oil Base de Venezuela had subagent or distributorship agreements in effect covering the countries of Colombia, Peru, and Mexico.

These subagent or distributor agreements provided for rates of commission, approximately equal to those which had been in effect in the agreement between petitioner and Baritina.

Certain of the petitioner's employees rendered services for Oil Base de Venezuela, and by reason of an agreement between the petitioner and Oil Base de Venezuela, the compensation of such employees for the time spent rendering services for Oil Base de Venezuela and any expenses incurred in such connection were borne equally by the petitioner and by Oil Base de Venezuela and proper charges were made on the books of account of both corporations.

The petitioner's direct profit from sales for its fiscal years ending in 1956, 1957, 1958, and 1959 expressed as a percentage of gross sales from the standpoint of total sales, domestic sales and export sales were as follows:

Period Ended	9-30-56	9-30-57	9-30-58	9-30-59
Total	24.7%	21.6%	32.0%	23.0%
Domestic	22.4%	14.0%	21.2%	22.5%
Export	34.6%	30.1%	45.6%	23.9%

The percentages expressed above represent the direct profit after deducting from gross sales all discounts and commissions allowed, the manufacturing costs of the goods sold, any patent royalties paid with respect to the goods sold, and the direct selling expense, which includes salesmen's salaries, traveling and entertaining expenses.

The results of Oil Base de Venezuela's operations for the three and one-half (3½) month period ended

September 30, 1958, and for the full year ended September 30, 1959, are as follows:

Period Ended	9-30-58*	9-30-59
Sales	$20,742.	$192,424.
Cost of Goods Sold	12,297.	130,451.
Commission Income	18,705.	99,933.
Other Income	450.	1,800.
Expenses	9,392.	82,675.
Net Income	18,208.	81,031.

*3½ month period

The results of Oil Base de Venezuela's operations for the years ended September 30, 1960, 1961, and 1962 are as follows:

Period Ended	9-30-60	9-30-61	9-30-62
Net Sales and Service Income	149,684.	78,400.	31,697.
Costs and Expenses	147,497.	90,717.	41,387.
Other Income	4,683.	13,022.	16,595.
Other Deductions	6,778.	1,199.	10,501.
Net Profit (Loss)	92.	(494.)	(3,596.)

The results of operation which is referred above were based upon statement prepared by Oil Base de Venezuela's certified public accountants and submitted by Oil Base de Venezuela to the petitioner. Such reports came to the petitioner in terms of the Venezuelan currency, which is the bolivar, and for the purposes of the proceeding below were converted to dollars at the rate of three and one-third (3⅓) bolivars to one United States dollar.

During the fiscal year in question, *i.e.*, September 30, 1959, Oil Base de Venezuela paid Venezuelan income taxes in the amount of $2,773.

For the petitioner's fiscal year ended September 30, 1959, the Commissioner of Internal Revenue determined

that commissions paid and discounts allowed by petitioner to Oil Base de Venezuela with respect to sales of petitioner's products within Venezuela were excessive to the extent they exceeded those which would have been paid or allowed pursuant to the rates of commission and discount which prevailed under the Baritina contract, and reallocated such alleged excessive amounts to petitioner under the provisions of Section 482 of the Internal Revenue Code. Further, the Commissioner of Internal Revenue entirely disallowed as deductions all commissions paid by petitioner to Oil Base de Venezuela with respect to sales of petitioner's products outside of Venezuela.

The Tax Court below whose decision was affirmed by the Court of Appeals sustained the Commissioner of Internal Revenue's determination insofar as it had reference to the commissions paid and discounts allowed on sales within Venezuela, but allowed the petitioner deductions for commissions paid on sales outside Venezuela in an amount equal to those which would have been paid pursuant to the commission rates prevailing in the Baritina contract.

That portion of the determination of the Commissioner of Internal Revenue which was sustained by the Tax Court and the Court of Appeals had the effect of reducing the profit of Oil Base de Venezuela from $81,031 to approximately $8,666, a percentage reduction of roughly 89.31%.

This case was tried originally in the Tax Court of the United States pursuant to the provisions of 26 U.S.C. Sections 6213, 7442.

Reasons for Granting the Writ.

The decision of the Court of Appeals below compounds the confusion already existing in an increasingly important area of federal law, that of federal taxation as it relates to international business operations. The question involved badly needs the consideration and definitive determination of this Court. A recognized authority in this area of federal taxation writing in the Proceedings of the New York University Twenty Fourth Annual Institute on Federal Taxation at page 1433 states as follows:

> "A discussion of inter-company pricing issues at this stage in the development of the law is very much a shot in the dark. Although the Treasury Department has promised regulatory guidelines in the area, these have not appeared as of this writing. The history of section 482 and its predecessor provision has provided a scattering case law, but much of this seems in conflict—on methodology, as well as substantive result. Attempts to reconcile decisions obviously stemming from basic differences in outlook by individual judges may only be misleading. It is probably wiser to rest with the uncomforting conclusion that the decisions are not all guidelines, or at least not all equally good ones.
>
> At the same time, there has been a great surge in audit activity by the Internal Revenue Service in this area. Particularly since pricing cases are among those in which Revenue Procedure 64-54 leaves the Service free to proceed for pre-1963 years, there is a wide and growing field of law

> building up. The Institute has presented able papers on this subect in the past; and only this broadening importance of the subject matter, plus two or three interesting developments since the latest presentation, justifies this new treatment."

Even since the paper in which the above quotation appears was written (early 1966) the Internal Revenue Service has on April 1, 1966 published proposed Regulations to section 482 of the Internal Revenue Code, has on August 2, 1966 withdrawn those proposed Regulations published on April 1, 1966 and published new proposed Regulations to section 482. *Federal Register, August 2, 1966.* Additionally, the Internal Revenue Service announced on August 2, 1966 that the Internal Revenue Bulletin of August 22, 1966 will contain Rev. Proc. 66-13 and an amendment to Rev. Proc. 65-17, 1965-1 C.B. 833, both of which deal with problems concerning the allocation of income, etc. between a domestic corporation and its controlled foreign corporation. See Technical Information Releases Nos. 836 and 837. Also on August 2, 1966 the Internal Revenue Service announced its reason for acquiescence in *Smith-Bridgman & Co.* 16 T.C. 287 and explained its position in regard to *Tennessee-Arkansas Gravel Co.,* 112 F. 2d 508 (CA-6, 1940), both of which cases deal with allocation under the precursor of section 482. The attention now being given this area by the Internal Revenue Service clearly demonstrates that not only is this an important area of tax law administration but also that substantial confusion exists with respect to it.

Both the federal officials charged with the duty of administering the tax laws and taxpayers attempting to frame business transactions in the light thereof are en-

titled to an end to this confusion and more definite guidelines. Only this Court can do this.

Section 482 of the Internal Revenue Code of 1954 has been a part of the Internal Revenue Code since the Revenue Act of 1928, and has remained substantially unchanged since that time.[1] The section is set forth verbatim at page 2 hereof.

The report of the Ways and Means Committee on the Revenue Act of 1928 describes the evils which section 482 was designed to correct:

> The section of the new Bill provides that the Commissioner may in the case of two or more trades or businesses owned or controlled by the same interest, apportion, allocate, or distribute the income or deductions between or among them, as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of "milking") and in order clearly to reflect their true liability.[2]

Accordingly, the underlying practices at which section 482 was aimed were "the shifting of profits, the making of artificial sales" and other similar devices for "milking" trades or businesses of profits.

The authority granted to the Commissioner of Internal Revenue in section 482 and its predecessors has been exercised by him in two basic situations. One,

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[1]Section 45 of the Internal Revenue Code of 1939 was amended by section 128(b) of the Revenue Act of 1943 to delete the words "gross income or deductions" and substitute therefor "gross income, deductions, credits, or allowances."

[2]H. R. Rep. No. 2, 70th Congress, First Session 16 (1927); S. Rep. No. 960, 70th Congress, First Session 24 (1928).

in those cases involving transactions between controlled taxpayers where no sound business purpose exists, and two, in cases dealing with transactions between controlled businesses where a sound business purpose does exist, but which are allegedly consummated with too great a tax advantage. In the former situation an allocation has been made which has the effect of completely ignoring a taxable entity where there appears to be no business purpose for its existence. In the latter situation, allocations are made by the Commissioner to achieve what he considers to be a clear reflection of the taxable income of the controlled businesses. In situations where all of the controlled businesses are subject to United States income taxation, the tax effect of the allocation on one of the controlled businesses is usually offset either sooner or later by the reciprocal adjustment to the taxable income of the other controlled business or businesses. In situations, however, where one or more of the controlled businesses is subject to United States income taxation and one or more of the controlled businesses is not, great harm can be done and the Commissioner of Internal Revenue should be required to exercise his authority with utmost caution.

Although the statute itself establishes no such standard, and although no such standard can be derived from any statements of Congressional intent, the Commissioner of Internal Revenut takes the position that the standard to be applied in every case where an allocation is to be made between controlled businesses is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Income Tax Regulations Section 1.482-1(b)(1).

In *Frank v. International Canadian Corp.*, 308 F. 2d 520 (C.A. 9, 1962) the Court of Appeals for the Ninth Circuit had before it a question of an allocation of income by the Commissioner of Internal Revenue pursuant to Section 45 of the 1939 Internal Revenue Code between a domestic parent corporation and its wholly owned Western Hemisphere trade corporation. In the *Frank* case the taxpayer (referred to herein as "Pennsalt") was a manufacturing corporation. It organized a Washington corporation (International) for the sole purpose of selling certain of Pennsalt's products to Canadian customers. These products had previously been sold to such Canadian customers by Pennsalt itself. It was the intention of Pennsalt in forming International that the latter would qualify as a Western Hemisphere trade corporation within the meaning of Section 109 of the 1939 Internal Revenue Code. The specific question involved was whether or not the prices which Pennsalt charged International for the products which International purchased from Pennsalt and in turn sold to the Canadian customers were such as to distort the true income of the controlled corporations. The Commissioner of Internal Revenue, of course, contended that the price structure for the products involved should have been that which would have resulted from bargaining between the parties dealing at arm's length. The District Court in this case, however, had found that the price structure resulted in a reasonable rate of return being received by Pennsalt, the manufacturing corporation, and that such was sufficient for the purpose of determining the true net income of the controlled corporations.

The Court of Appeals in the *Frank* case in speaking with respect to the Commissioner of Internal Revenue's arm's length bargaining argument, stated as follows:

> "But entirely aside from the appellee's position that the Commissioner is precluded from advancing this argument on appeal, we do not agree with the Commissioner's contention that 'arm's length bargaining' is the sole criterion for applying the statutory language of section 45 in determining what the 'true net income' is of each 'controlled taxpayer'. Many decisions have been reached under Section 45 without reference to the phrase 'arm's length bargaining' and without reference to Treasury Department regulations and rulings, which state that the talismanic combination of words—'arm's length'—is the standard to be applied in every case.
>
> "For example, it was not any less proper for the District Court to use here the 'reasonable return' standard than it was for other Courts to use 'full fair value' 'fair price, including a reasonable profit' 'method which seems not unreasonable' 'fair consideration which reflects arm's length dealing' 'fair and reasonable' 'fair and reasonable' or 'fair and fairly arrived at' or 'judged as to fairness' all used in interpreting Section 45." (308 F. 2d at 528-529).

In a footnote this Court then cites the following cases as supporting the second paragraph of the above quoted portion of the decision.

The Friedlander Corp., 25 T.C. 70, 77 (1955);

Grenada Industries, Inc., 17 T.C. 231, 260 (1951). Affirmed 202 F. 2d 873, certiorari denied 346 U.S. 819;

Motors Securities Co., Inc., 11 T.C.M. 1074, 1082 (1952);

Palm Beach Aero Corp., 17 T.C. 1169, 1176 (1952);

Polak's Frutal Works, Inc., 21 T.C. 953, 975-976 (1954); and

Seminole Flavor Co., 4 T.C. 1215, 1232 (1945).

In making the statement quoted above, the Court of Appeals in the *Frank* case was not speaking strictly within the confines of the facts before it in that case. It was, on the other hand, enunciating what it considered to be an established rule of law based upon the cases which it cites in support thereof. The *Frank* case clearly stands for the proposition that if a taxpayer meets either the "fair and reasonable" criterion, or the "arm's length bargaining" criterion, the Commissioner may not reallocate income deductions, etc., under the provisions of Section 482.

It is also clear that the Congress believed and understood that the standard under Section 482 with respect to inter-company sales to be a fair or reasonable price. This is clearly evidenced by the following statements made by the House Committee on Ways and Means when in 1962 it was studying the effect of Section 482 in the specific area of inter-company pricing:

> "Present law in Section 482 authorizes the Secretary of the Treasury to allocate income between related organizations where he determines this al-

location is necessary 'in order to prevent evasion of taxes or clearly to reflect the income of any such organizations.' This provision appears to give the Secretary the necessary authority to allocate income between domestic parent and its foreign subsidiary. However, in practice the difficulties in determining a *fair price* under this provision severely limit the usefulness of this power, especially where there thousands of different transactions engaged in between domestic company and its foreign subsidiary." (Emphasis added).[3]

In the instant proceeding below the petitioner established that in making domestic sales of its products, it sold directly to its customers through its own selling personnel. With respect to its export sales the petitioner established that it sold through sales representatives who received a discount or commission with respect to such sales. The petitioner further established that despite the rates of commission and discount which were paid or allowed to Oil Base de Venezuela, which the Commissioner of Internal Revenue deemed excessive, the return on its manufacturing activity with respect to export sales was equal to or greater than the return on its manufacturing activity with respect to domestic sales. The petitioner contended, therefore, that its transactions with its foreign subsidiary were "fair and reasonable" since the price it received for manufacturing the products which were sold abroad, produced for it a return which was equal to or greater

[3]H. R. Rep. No. 1447, 87th Congress, Second Session, 28 (1962).

than the return on its manufacturing activity with respect to products which were sold to unrelated parties.

In the instant proceeding the Court of Appeals below in commenting on its prior decision in the *Frank* case states that the *Frank* case did not hold that the arm's length standard established by Regulation was improper. The petitioner does not so contend. The Court of Appeals below further notes that the *Frank* case held that the arm's length standard was not "the sole criterion" for determining the true net income of each controlled taxpayer, and then goes on to state:

> "However, permissible departure from the Regulations' arm's length standard was under the facts of that case very narrowly limited."

It is respectfully submitted by the petitioner, however, that the enunciation of the Court of Appeals in the *Frank* case that the arm's length standard was not the sole criterion was not made solely with reference to the facts of the *Frank* case. It was stated as a basic proposition of law, and as stated above, the clear implication is that if a taxpayer satisfies either of such criterion, the Commissioner may not reallocate under Section 482.

The holding of the Court of Appeals in the instant proceeding below substantially obscures the state of law in this area. The Commissioner of Internal Revenue in his Regulations continues to take the position that the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length

with another uncontrolled taxpayer. The clear holding of the Court of Appeals in the *Frank* case was that this was not the *sole* criterion, but that the taxpayer would prevail if it could show that its dealings with its controlled business were fair and reasonable. In limiting the application of the fair and reasonable doctrine, the Court of Appeals in the instant proceeding creates such uncertainty in the area of inter-company pricing in international business operations, as to profoundly affect the conduct thereof.

A further question which begs clarification by this Court is whether the authority granted to the Commissioner of Internal Revenue by Section 482 is such as to permit him to create a loss in one of the controlled businesses.

In the instant proceeding the petitioner established in the Courts below that the same agreement between the petitioner and Oil Base de Venezuela, including the rates of commission and discount which the Commissioner of Internal Revenue deemed excessive, was in effect not only during the year before the Courts below, that being the petitioner's fiscal year ended September 30, 1959, but also during the fiscal years ended in 1960, 1961, and 1962. As shown in the Statement of the case in this Petition, Oil Base de Venezuela for its fiscal year ended in 1960 showed a net profit of Ninty-Two Dollars ($92.00). For its fiscal year ended in 1961 it suffered a loss of Four Hundred Ninety-Four Dollars ($494.00), and for its fiscal year ended in 1962 a loss of Three Thousand Five Hundred Ninety-Six Dollars ($3,596.00). The foregoing are the results of Oil Base de Venezuela's operations prior to the reallocation of income made by the Commissioner

of Internal Revenue. It is readily apparent that if the basis of reallocation made by the Commissioner of Internal Revenue in the fiscal year ended in 1959 is applied to the three ensuing years, the small profit which it realized in its fiscal year ended in 1960 will be changed to a loss, and the losses which it suffered in the fiscal years ended in 1961 and 1962 will be substantially enlarged. At the same time, the taxable net income of the petitioner is correspondingly enlarged. In comparing the operating results of the two corporations on a consolidated basis, both before and after the reallocation proposed by the Commissioner of Internal Revenue, it would appear that the Commissioner is creating income taxable by the United States where in fact none actually exists.

Additionally, assuming *arguendo* that arm's length bargaining is the standard to be applied in every case, can it be said that parties dealing at arm's length would enter into transactions which would force one of the arm's length bargaining parties to operate at a loss? It is submitted that the question supplies its own answer.

Accordingly, it is respectfully submitted that the Congress in granting to the Commissioner of Internal Revenue the power to reallocate certain items of income deductions, etc., did not intend to confer upon the Commissioner the power to force one of the controlled taxpayers to operate at a loss while increasing the income of the other controlled taxpayer; that the instant proceeding is a glaring example of the fact that the Commissioner is exercising such power to such effect, and it is further submitted will continue to do so unless this Court places a limitation upon such power.

Conclusion.

A question of ever increasing importance in the administration of the Federal tax laws and the ability of the business community to frame international business transactions in the light thereof has been thrown into an even greater state of confusion by the decision of the Court of Appeals for the Ninth Circuit in the instant proceeding. Only this Court can end this confusion, and create an environment of reasonable certainty within which international business operations can be conducted. We urge the Court, therefore, to grant the Writ of Certiorari.

Respectfully submitted,

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APPENDIX I.

Judgment.

United States Court of Appeals For the Ninth Circuit.

Oil Base, Inc., Petitioner, vs. Commissioner of Internal Revenue, Respondent. No. 20,073.

Upon Petition to Review a Decision of The Tax Court of the United States.

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed.

Filed and entered May 23, 1966.

APPENDIX II.

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals, for the Ninth Circuit.

Oil Base, Inc., Petitioner, vs. Commissioner of Internal Revenue, Respondent. No. 20,073.

[May 23, 1966]

On Petition for Review of a Decision of the Tax Court of the United States.

Before: Merrill and Browning, Circuit Judges, and Thompson, District Judge.

Merrill, Circuit Judge:

Petitioner as taxpayer seeks review of a Tax Court decision respecting income taxes for the taxpayer's fiscal yaar ending September 30, 1959. The case involves allocation of income between the taxpayer and its subsidiary, a wholly owned Venezuela corporation, Oil Base de Venezuela, C.A. (hereinafter referred to as "Obvenca"), which, during the year in question, served as taxpayer's foreign sales representative.

The income derived by Obvenca was attributable to commissions and discounts allowed by the taxpayer pursuant to an agreement between the two companies. Finding these commissions and discounts to be roughly twice as large as those paid or allowed by taxpayer in agreements with five separate uncontrolled foreign sales representatives (including Obvenca's Venezuelan predecessor and three of Obvenca's subagents), the Com-

missioner, under section 482, Internal Revenue Code of 1954,[1] rejected the terms of the agreement as not clearly reflecting the income of the parties and having the effect of improperly shifting income from taxpayer to its controlled foreign subsidiary. Pursuant to Treasury Regulations[2] the Commissioner allocated to taxpayer that income which the arm's-length arrangements

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[1]Internal Revenue Code of 1954:

"SEC. 482. ALLOCATIONS OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses." (26 U.S.C. 1958 ed., Sec. 482.)

[2]Section 1.482-1(b) provides in part:

"*Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer."

Section 1.482-1(a)(6) provides:

"The term 'true taxable income' means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto)."

with uncontrolled foreign sales representatives would have produced.[3] The Tax Court supported the Commissioner. We agree.

As stated by the Tax Court in its opinion:

> "The burden is on petitioner to show error in respondent's allocation and respondent's determination must be sustained unless it is unreasonable, arbitrary or capricious."

Taxpayer contends here, as it did before the Tax Court, that the Commissioner has erred in establishing by regulation and using here a standard of arm's-length bargaining. Taxpayer points out that no such standard is contained in the statute. It contends that under the statute the question is not what income arm's-length bargaining would have produced, but what income properly is attributable to each of the two commonly held corporations as its true net income in light of what each performs or produces. Relying on this court's decision in *Frank v. International Canadian Corporation*, 308 F.2d 20, 528-529 (9th Cir. 1962),

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[3]The Commissioner explained his adjustment to the taxpayer as follows:

> "It is determined that commissions paid and discounts allowed to your controlled foreign subsidiary, Oil Base de Venezuela, C.A. were excessive in amount and had the effect of improperly shifting income from you to your controlled foreign subsidiary, thereby distorting your income and the income of your subsidiary. Furthermore, sales commissions were paid to Oil Base de Venezuela on certain sales occurring outside of Venezuela which were, in substance, your sales and on these sales no commissions are being allowed under this determination. In determining the proper amount allowable as commissions and discounts paid to Oil Base de Venezuela, C.A. where some amount is properly allowable, the determination has been based on arm's length negotiated rates between yourselves and uncontrolled parties on identical goods and services. This issue involves application of sections 61 and 482 of the Internal Revenue Code of 1954."

it contends that in the present case the question is whether the income reported by taxpayer is a fair and reasonable return on its retained manufacturing activity.[4]

We cannot agree. Where, as here, the extent of the income in question is largely determined by the terms of business transactions entered into between two controlled corporations it is not unreasonable to construe "true" taxable income as that which would have resulted if the transactions had taken place upon such terms as would have applied had the dealings been at arm's length between unrelated parties.

Frank v. International Canadian Corporation, supra, did not hold that the arm's-length standard established by regulation was improper. It held that it was not "the *sole* criterion" for determining the true net income of each controlled taxpayer. However, permissible departure from the regulation's arm's-length standard was, under the facts of that case, very narrowly limited[5] and the holding has no application to the facts before us.

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[4]Taxpayer asserts that this has been conclusively established by proof that even after payment of the commissions and allowances of the discounts in question, it has realized a higher return on its manufacturing activity in respect to foreign sales than it has in respect to its domestic sales. The Tax Court dismissed this contention with the comment:

> "There is no evidence to show that the percentage return retained by petitioner on domestic sales would represent a reasonable return on its export sales."

[5]It was held: (1) that where the pretrial order pursuant to stipulation specified that the standard to be applied was "reasonable price and profit," the District Court was not in error in applying that standard; and (2) that the court was not in error in holding the price and profit to be reasonable where (a) the price charged resulted in a reasonable return to the retained manufacturing activity, and (b) there was no evidence that

(This footnote is continued on the next page)

We conclude that the arm's-length bargaining standard was properly applied pursuant to regulation. *Hall v. Comm'r,* 294 F.2d 82 (5th Cir. 1961).

Taxpayer contends that certain factors bearing on Obvenca's business activities distinguish its situation from that of its predecessor and render the arm's-length history irrelevant and its return inadequate. It contends that adjustment should be made to compensate for these factors and that doubling the commissions and discounts previously paid was reasonable adjustment.

The Tax Court considered these factors and rejected taxpayer's contentions with respect to them. For the reasons expressed by the court we do not regard this ruling as arbitrary or unreasonable under the circumstances.

Affirmed.

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arm's-length bargaining upon the specific commodities sold had produced a higher return. Further, from the complexity of the circumstances surrounding the services rendered by the subsidiary it appears that it would have been difficult for the court to hypothesize an arm's-length transaction.

APPENDIX III.

Memorandum Findings of Fact and Opinion.

T. C. Memo 1964-298

Tax Court of the United States

Oil Base, Inc., Petitioner, v. Commissioner of Internal Revenue, Respondent. Docket No. 2289-63.

Filed November 17, 1964.

Wilson B. Copes, for the petitioner.

John W. Alexander, for the respondent.

Scott, *Judge:* Respondent determined a deficiency in petitioner's income tax for its fiscal year ended September 30, 1959, in the amount of $51,718.66.

The issues for decision are:

(1) Whether respondent properly included in petitioner's income under the provisions of section 482 of the Internal Revenue Code of 1954 a portion of the commissions paid and discounts allowed to petitioner's wholly owned foreign subsidiary.

(2) Whether respondent properly disallowed petitioner's deduction for all commissions paid to its wholly owned subsidiary on sales of petitioner's products in countries other than Venezuela.

FINDINGS OF FACT.

Some of the facts have been stipulated and are found accordingly.

Petitioner is a California corporation with its principal place of business in Houston, Texas.

Petitioner's income tax return for its fiscal year ended September 30, 1959, was filed with the district director of internal revenue for the Sixth District of California.

During its fiscal year 1959 petitioner's principal place of business was in Compton, California.

Petitioner is and has been since prior to 1946, engaged in the business of manufacturing and selling oil base drilling fluid and related products to the oil drilling industry.

Since approximately 1946 petitioner has been selling its products in certain foreign countries where oil drilling activity was being conducted.

Petitioner's principal product is an oil base drilling fluid known as "Black Magic." Black Magic is a specialized product for use in the oil drilling industry possessing certain qualities not found in water base drilling fluids. It produces highly desirable results in certain specialized oil well drilling situations. The product is more expensive than water base drilling fluids and is dirty and disagreeable to work with. For this reason petitioner considers it necessary to direct its selling efforts to all levels of oil drilling personnel ranging from the top production executives of an oil company down to the drilling crews. Generally, it requires more than one contact to result in a sale of petitioner's product.

Service of the use of petitioner's products after a sale is also an important feature of petitioner's business. Petitioner maintains a staff of service engineers whose main duty is to service and supervise the use of its products by its customers. All of petitioner's sales and service engineers are trained in the use of petitioner's products and petitioner's top executives are likewise trained.

A true oil base drilling fluid is used in approximately 2 percent of all oil wells drilled. Thare are several

companies which manufacture and sell a true oil base drilling fluid, and these companies other than petitioner are petitioner's direct competitors.

Prior to October 1, 1955, petitioner's foreign sales had been accomplished through various independent sales representatives.

On or about October 1, 1955, petitioner and Baritina de Venezuela, S.A., a Venezuelan corporation of Caracas, Venezuela (hereinafter referred to as Baritina), executed an agreement pursuant to which Baritina was to act as the exclusive sales representative for petitioner's products in the country of Venezuela. This agreement provided that Baritina would diligently and faithfully prosecute the sales of petitioner's products and would forward to petitioner all orders to be shipped by petitioner directly to Baritina's customers, that Baritina would pay its own costs and expenses and would maintain at its own expense an adequate and competent staff of sales engineers in connection with the selling and servicing of petitioner's products. It further provided that Baritina would send one or more persons to petitioner's Compton plant for instruction in the use and sale of petitioner's products. The agreement also provided that Baritina would not sell or attempt to sell any product similar to petitioner's products without petitioner's consent. The agreement contained in addition other general provisions with respect to liabilities of the parties, claims, and prices of merchandise, and it contained the following provision with respect to Baritina's commissions and discounts:

> 8. First Party (OIL BASE, INC.) agrees to pay to Second Party [Baritina] as commissions upon merchandise shipped directly by First Party

to the consumers within Second Party's territory, as hereinafter set forth under heading (a) of this paragraph contained; First Party does further agree to allow Second Party discounts from its list price of merchandise hereinafter listed as may be purchased by Second Party from First Party for resale and stocked or warehoused by it, as hereinafter set forth under headings (b) and (c) of this paragraph contained:

	(a) (commission)	(b) Net 90 days from date of invoice (discount)	(c) Net 90 days from date of invoice (discount)
OB Wate	15%	17½%	20%
Filer Presses	15%	17½%	20%
Chemical "V"	15%	17½%	20%
OB Zero	15%	17½%	20%
Mix Fix	15%	17½%	20%
Additive "E"	15%	17½%	20%
Sacked Black Magic	20%	22½%	25%
OB Gel	20%	22½%	25%
OB Gen	20%	22½%	25%
White Magic	20%	22½%	25%
Economagic	20%	22½%	25%
Peptomagic	20%	22½%	25%
No-Glo Oil	20%	22½%	25%
No-Glo Thread Lubricant Special Additive 58	20%	22½%	25%
Formaseal	20%	22½%	25%
Mud Guns	20%	22½%	25%
Well Wash	20%	22½%	25%
Chemical "W"	20%	22½%	25%
Black Magic Premix	20%	22½%	25%
Hand Cleaner	20%	22½%	25%

The foregoing may be amended in writing endorsed thereon.

On or about December 1, 1955 petitioner and Baritina executed a document entitled "Supplemental Agreement" pursuant to which the country of Colombia was added to the territory for which Baritina was to be the exclusive representative of petitioner's products. This supplemental agreement further provided that A Z Export, S.A., a corporation, was to be named as the exclusive subagent and distributor of petitioner's products in the Republic of Colombia.

The agreement between petitioner and Baritina with the supplement including sales in the Republic of Colombia, remained in force through September 30, 1957.

After September 30, 1957, and during the period of time in which Baritina and petitioner were negotiating in an effort to reach a new agreement Baritina continued to sell petitioner's products even though no written contract in this respect between the two parties was in effect.

Prior to October 1, 1955, while petitioner was represented by independent sales representatives in selling its products in foreign countries petitioner sent personnel from its own plant to assist its sales representatives in the sales and servicing of petitioner's products even though some of the sales representatives had personnel who had been trained in the uses and applications of petitioner's products.

During the time that Baritina was representing petitioner, petitioner furnished Baritina one of its own experienced engineers who went to Venezuela and became

employed by Baritina. This engineer while employed by Baritina, worked primarily on sales of petitioner's products.

After the termination of the agreement between petitioner and Baritina on September 30, 1957, the two companies negotiated for the renewal and modification of the agreement. These negotiations consisted of correspondence between the two companies, and representatives of petitioner and a representative of Baritina had one personal conference. The personal conference took place in petitioner's offices at Compton, California, and petitioner was represented by its president and executive vice president, and Baritina by its assistant general manager. Petitioner's representatives, in these negotiations, took the position that since 40 percent of Baritina's stock has been acquired by National Lead Company, which operated a division called the Baroid Division which was a direct competitor of petitioner, petitioner should have protection with respect to the time period of the contract and quantity of inventory carried by Baritina. In addition, petitioner wanted Baritina to erect a premix plant in order that petitioner's products might be shipped in a dry state to Venezuela and mixed in liquid form in that country. Petitioner also wanted Baritina to agree to send four or more persons to its plant at Compton for training.

During the course of the negotiations Baritina requested higher commissions and discounts. At the personal conference between representatives of petitioner and of Baritina, petitioner's representatives received the impression that the representative of Baritina had authority to agree to a contract on behalf of Baritina and at the conclusion of the conference were under

the impression that an agreement had been reached between the two companies regarding the provisions of a new contract. In accordance with this understanding petitioner's president, under date of March 10, 1958, submitted to the general manager of Baritina a proposed new contract to be entered into between the two companies as of April 1, 1959, which proposed contract he understood to be in accordance with the agreement reached at the personal conference. The proposed agreement submitted by petitioner's president to Baritina with a letter dated March 10, 1958, was for a period of 1 year and contained, among its provisions, the following:

> 3. Baritina agrees to:
>
> * * * * *
>
> (e) Maintain at its own expense an adequate and competent staff of "sales engineers" in connection with the selling and servicing of Oil Base's products, it being agreed that service by trained and skilled personnel is necessary to the proper use by the consumer of Oil Base's products and to the proper sales coverage thereof.
>
> In connection with the foregoing, Baritina agrees to send four or more persons to Oil Base's plant at Compton, California, within a period of one hundred twenty (120) days from date hereof for instruction in the use, and sales procedures adopted by Oil Base in connection with the consumer use and sale of its products, to wit: For instruction as a "sales engineer" as said term is herein used. All transportation, living, maintenance, and salary expenses of and for such persons shall be borne and paid by Baritina; provided, however, that Bari-

tina may at its option in lieu of sending the aforedescribed four persons for training at Oil Base's plant at Compton, California, as sales engineers, request Oil Base to send one of its trained sales engineers to Venezuela to train and instruct said four persons as sales engineers, all expenses of said representative, including salary, to be borne and paid by Baritina. The request and sending of said representative as last described shall constitute full performance of this Subparagraph (e) by Baritina.

* * * * *

9. Baritina agrees to maintain at all times during the existence of this agreement a minimum stock of Oil Base material in the following quantities at the listed points or warehousing sites, to wit:

* * * * *

* * * Having this in mind, Baritina agrees that the aforedescribed inventory shall never at any time during the term of this Agreement or extension hereof be allowed to go below and remain below a minimum purchase price value of $100,000.00, * * *

10. It is understood that Baritina has made certain sales of all Oil Base's products in Colombia and Venezuela during the months of October, 1957, through March, 1958 during which times Baritina had no sales representation agreement with Oil Base and no agreement with respect to payment by Oil Base of any commissions to Baritina on account of said sales, it being further agreed that calculated amounts of said commissions exceeds

$15,000.00. In consideration of Oil Base paying said described commissions in such exact amount as the same may appear and be, Baritina agrees to immediately erect at its sole expense a premix plant in accord with bluprints [*sic*] furnished to Baritina by Oil Base. Said premix plant shall be erected at Las Morochas, Venezuela, for use in the processing, storage and sale of Oil Base products. Payment of said described commissions shall be made when said plant is erected and in operation.

* * * * *

14. Baritina agrees that it will maintain two trained sales engineers (trained as provided in paragraph 3(e)) resident in the Republic of Colombia at all times during the existence of this Agreement. * * *

The commissions and discounts set forth in the proposed agreement were identical to those which had been contained in the prior agreement between petitioner and Baritina. The term of 1 year in the contract was in accordance with information that the assistant general manager of Baritina had given to representatives of petitioner subsequent to the personal conference between representatives of the two companies to the effect that the general manager of Baroid Sales Division of National Lead Company would agreed to a 1-year term only for the contract.

Subsequent to the submission of the proposed contract to Baritina by letter dated March 10, 1958, further correspondence took place between representatives of petitioner and representatives of Baritina in which the representatives of Baritina stated that Baritina could not agree to the new provision of the proposed con-

tract which required Baritina to keep a minimum inventory and to construct a premix plant in Venezuela. The estimated cost of construction of the premix plant was approximately $25,000.

In a letter dated March 17, 1958, from the assistant general manager of Baritina to petitioner's president discussing the proposed new contract, the following statement was made:

> We are more than willing to continue on the basis of the old contract, making whatever new arrangements within reason which you feel are necessary in Columbia [*sic*]. This would mean putting at least one permanent sales and service representative in Bogota. In Venezuela, we must be clear in stating that we cannot agree to building a Mixing Plant or maintaining minimum inventories at the present time.
>
> May we hope that you can see your way clear to extend the old contract or a modified form of the new contract excluding those portions commented on in the preceding paragraphs.

At the time the negotiations were being carried on with respect to a new contract between petitioner and Baritina, the latter company was maintaining in Venezuela an inventory of petitioner's products in an amount of approximately $85.000.

The proposed new contract between petitioner and Baritina was never executed and negotiations were terminated in April of 1958.

After termination of negotiations between petitioner and Baritina regarding the new contract, petitioner's management gave consideration to the best method of

marketing petitioner's products in foreign countries. After consulting counsel in Los Angeles, California and a Venezuelan attorney, petitioner's board of directors decided to form a wholly owned Venezuelan corporation to act as petitioner's sales representative in foreign countries. On or about July 13, 1958, petitioner caused the formation of Oil Base de Venezuela, C.A. a Venezuelan corporation (hereinafter referred to as Oil Base, Venezuela) as a wholly owned subsidiary of petitioner. Oil Base, Venezuela was organized with a paid-in capital of $6,000 and at no time during the fiscal year ended September 30, 1959, was this paid-in capital increased. On or about June 20, 1958, petitioner and Oil Base, Venezuela, executed an agreement pursuant to which Oil Base, Venezuela, was to act as petitioner's exclusive sales representative for the sale of petitioner's products in all countries of the world except all of the States of the United States and all of the Provinces and Dominions of Canada. Section 8 of this agreement provided as follows:

> 8. O.B.I. agrees to pay O.B. Ven., as commissions upon merchandise shipped directly by O.B.I. from any of its plants or warehouses located in the United States of America to a customer located within O.B. Ven.'s territory, such sum as will represent twenty per cent (20%) of the net invoice billings of said sales, exclusive of transportation, packaging, insurance and taxes, of those products of O.B.I. known as OB Wate, Filter Presses, Additive "V", OB Zero, MixFix, Additive "X" and Additive "E"; and such sum as will represent forty per cent (40%) of the net invoice billings of sales, exclusive of transportation, pack-

aging, insurance and taxes, of all other of O.B.I.'s products. O.B.I. does further agree to allow O.B. Ven. discounts of twenty per cent (20%) from its established export list price of its products, exclusive of freight, taxes and special charges for export crating, known as OB Wate, Filter Presses, Additive "V", OB Zero, MixFix, Additive "X" and Additive "E"; and discounts of forty per cent (40%) from its established list price, exclusive of freight, taxes and special charges for export crating, on all other of O.B.I.'s products. If such commissions are due O.B. Ven. because of direct purchases made from O.B.I. by customers operating in O.B. Ven.'s territory as aforedescribed, such commissions shall be determined and paid on the 20th day of the month next succeeding the month in which payment is made to O.B.I. by such customers.

The agreement between petitioner and Oil Base, Venezuela, was for a period commencing June 20, 1958, and ending January 1, 1959, but this agreement was extended for an additional year to December 31, 1959. The agreement between petitioner and Oil Base, Venezuela, made no requirement of a minimum inventory to be maintained by Oil Base, Venezuela, for the erection of a premix plant, the training of four sales engineers in petitioner's plant, or the maintenance of two sales engineers in Colombia.

On July 1, 1958, Oil Base, Venezuela, entered into a written agreement with M. R. Vollmer and M. L. Cooper referred to in the agreement as "Volco", under which Volco was designated as exclusive sales representative of petitioner's products in the country of Co-

lombia. Under the provisions of this agreement Volco was to receive a 10 percent commission on products shipped directly by Oil Base, Venezuela, to customers within the country of Colombia. This agreement obligated Volco to maintain two trained sales engineers in the Republic of Colombia at all times during the existence of the agreement.

By assignment agreement dated November 24, 1958, the agreement between Oil Base, Venezuela, and Volco was assigned to Volco, Inc., a corporation of the country of Panama. Volco, Inc., was a corporation formed by M. R. Vollmer and M. L. Cooper. The assignment was agreed to by Oil Base, Venezuela. Prior to July 1, 1958, M. R. Vollmer and M. L. Cooper were representatives of an agent of Baritina in the Republic of Colombia and in that capacity sold and serviced petitioner's products in Colombia.

On October 1, 1958, Oil Base, Venezuela, entered into an agreement with Servicios Petroleros, S.A., a Peruvian corporation (hereinafter referred to as Servicios), under which Servicios was designated as the exclusive sales representative of petitioner's products in the country of Peru. This contract provided for the same commissions and discounts which had been provided for in petitioner's contract with Baritina and in the proposed contract of April 1, 1958, between petitioner and Baritina.

On October 1, 1958, Oil Base, Venezuela entered into an agreement with Gene L. Towle, under which Towle was designated as the exclusive sales representative of petitioner's products in Mexico. This contract provided for the same commissions and discounts as had been allowed by petitioner to Baritina and as set

forth in the proposed contract of April 1, 1958, between petitioner and Baritina.

The contracts between Oil Base, Venezuela and its three subagents were each signed by the president of Oil Base, Venezuela, who was also petitioner's president.

The agreement between Oil Base, Venezuela, and Volco, Inc., covering the period beginning July 1, 1959 and ending September 30, 1960, provided for commissions to be paid and discounts to be allowed to Volco, Inc., in the same amounts as had been allowed by petitioner to Baritina and as were being allowed to Servicios and Gene L. Towle.

On October 1, 1958, petitioner and Milwhite Mud Sales Co., Ltd. (hereinafter referred to as Milwhite), entered into a contract under which Milwhite was designated as the exclusive sale representative for petitioner's products in the Provinces of Alberta and Saskatchewan, Canada. The commissions and discounts allowed to Milwhite under this contract were exactly the same as those which had been allowed by petitioner to Baritina and which were set forth in the proposed contract of April 1, 1958, between petitioner and Baritina. Petitioner's agreement with Milwhite was for a 1-year period and was extended for an additional period to October 1, 1960.

During the period beginning June 20, 1958, and continuing until about December 20, 1958, Richard Newman was the only full-time employee of Oil Base, Venezuela. Newman was stationed in Puerto La Cruz, Venezuela. Prior to being employed by Oil Base, Venezuela, Newman had been employed as a sales engineer by Baritina in Venezuela and in that capacity he had sold and

serviced petitioner's products. Prior to becoming employed by Baritina, Newman had been employed as a sales engineer for petitioner. Newman severed his connections with Oil Base, Venezuela about December 20, 1958. A period of approximately 2 weeks expired before Newman's replacement arrived in Puerto La Cruz, Venezuela.

Newman's replacement was a man named White who had been employed by petitioner prior to becoming employed by Oil Base, Venezuela. White took over his duties with Oil Base, Venezuela, shortly after January 1, 1959. White was the only full-time employee of Oil Base, Venezuela, from the time he became so employed throughout the balance of the fiscal year ended September 30, 1959. Newman while employed by Oil Base, Venezuela, and White when he replaced Newman, served as sales engineer, service engineer, and general manager of Oil Base, Venezuela.

Shortly after Oil Base, Venezuela, was organized, a public accountant located in Venezuela was paid $75 to open a set of books for the newly organized corporation and it was agreed that this accountant would be paid for bookkeeping service for the corporation and in addition, with no additional charge, he would permit Oil Base, Venezuela, to use his post office box number in Puerto La Cruz and furnish an office for the general manager of Oil Base, Venezuela, to occupy from time to time. This accountant had other clients besides Oil Base, Venezuela. It was agreed that the payment for services, without any additional charge for the use of the post office box and furnishing an office, would be approximately $150 per month. The accounting practice of the accountant with whom Oil Base, Venezuela, made the

arrangement was purchased around the first of May 1959 by an accounting firm which continued the same arrangement with Oil Base, Venezuela.

During the fiscal year ended September 30, 1959, the president and vice president of petitioner, who were also the president and executive vice president of Oil Base, Venezuela, made a trip to Venezuela, and during the course of the trip visited Mexico and Colombia. Most of the time the two officers of petitioner and Oil Base, Venezuela, were traveling together. In the business dealings conducted in Venezuela, they represented themselves as officers of Oil Base, Venezuela. During some of the trip, the two officers were accompained by Newman, the manager of Oil Base, Venezuela. On the trip in Colombia, petitioner's two officers were accompanied by the Colombian agents who handled petitioner's products and represented themselves as officers of Oil Base, Venezuela. In accordance with the agreement between Oil Base, Venezuela, and petitioner, each of the companies bore one-half of the expense of the trip made by these officers to Venezuela, Colombia, and Mexico.

It had been petitioner's consistent practice during the years that it was marketing its products in foreign countries to send its employees to the countries in which its products were being sold for the purpose of assisting its sales representatives and servicing the use of its products. Petitioner's assistant sales manager was usually the representative sent to Venezuela and Colombia, and while on such trips he actually went to the site where petitioner's products were being used and serviced the use of petitioner's products. The expense of these trips was borne solely by petitioner.

As of September 30, 1958, Oil Base, Venezuela, had inventory of a value of $21,809 stored at a leased warehouse at Puerto La Cruz, Venezuela; and as of September 30, 1959, it had inventory stored at this warehouse of a value of $27,764. As of these same dates Oil Base, Venezuela, owned office equipment which had a cost of $758 and an automobile which had a cost of $3,611; and as of September 30, 1959, Oil Base, Venezuela, owned furniture for a manager's house which had a cost of $1,200.

During the fiscal period ended September 30, 1958, and the fiscal year ended September 30, 1959, Oil Base, Venezuela, leased a warehouse in Puerto La Cruz for Bs.500 per month. During the fiscal year 1959 it required three and one-third bolivars (Bs.) to equal one United States dollar.

During the fiscal period ended September 30, 1958, and the fiscal year ended September 30, 1959, Oil Base, Venezuela, leased a manager's house located at Phillips Camp at San Roque, Venezuela, for a monthly rental of BS.800 and a house located at Nalco Camp, Anaco, for a monthly rental of Bs.1,000.

For the fiscal year ended September 30, 1959, Oil Base, Venezuela, was charged for services rendered, $3,136.33 and $1,055.33 of the salaries paid by petitioner to its president and vice president, respectively, who were also the president and executive vice president of Oil Base, Venezuela. In addition petitioner's treasurer also rendered services for Oil Base, Venezuela, and for such services rendered by the individual who was petitioner's treasurer until July 1959, Oil Base, Venezuela, was charged $275.40 and for services rendered by the individual who became petitioner's treasurer on July

1, 1959, Oil Base, Venezuela, was charged $117.63 for services rendered during the fiscal year ended September 30, 1959.

Oil Base, Venezuela, had net income and retained earnings of $18,208 for the 3½ month period ended September 30, 1958, and a net income of $81,031 for its fiscal year ended September 30, 1959, and retained earnings of $99,259 for the fiscal year ended September 30, 1959. Petitioner's direct profit from sales for its fiscal years ending September 30, 1956, 1957, 1958, and 1959, expressed as a percentage of total gross sales, the similar direct profit for domestic sales expressed as a percentage of those sales, and export sales expressed as a percentage of such sales are as follows:

	Fiscal years ended September 30—			
	1956	1957	1958	1959
	Percent			
Total	24.7	21.6	32.0	23.0
Domestic	22.4	14.0	21.2	22.5
Export	34.6	30.1	45.6	23.9

Direct profit used in computing these percentages represents the profit after deducting from gross sales all discounts and commissions allowed, manufacturing costs of the goods sold, any patent royalties paid with respect to the goods sold, and the direct selling expenses including salesmen's expenses, salaries, and entertainment expenses.

Throughout the fiscal year ended September 30, 1959, petitioner owned all of the outstanding capital stock of Oil Base, Venezuela.

Each of the officers and directors of Oil Base, Venezuela, was also an officer of petitioner.

In May of 1958, prior to the organization of Oil Base, Venezuela, petitioner's vice president made a trip to Venezuela and Colombia, at which time he discussed with Newman, who was then employed by Baritina, employment in Venezuela by petitioner's proposed subsidiary. He also discussed with Vollmer and Cooper in Colombia their serving as sales representatives for petitioner's products in Colombia. At that time Vollmer and Cooper were employees of the subagent who was the distributor of petitioner's products in Colombia on behalf of Baritina.

Certain officers of petitioner who were also officers of Oil Base, Venezuela, carried on extensive correspondence on behalf of Oil Base, Venezuela, from petitioner's offices in Compton, California. Although the letterhead of Oil Base, Venezuela, was used for this correspondence, such correspondence was actually written in Compton, California by secretaries who were full-time employees of petitioner.

During the fiscal year ended September 30, 1959, between 80 and 85 percent of the sales of petitioner's products in the Republic of Colombia were made to Texas Petroleum Company in Colombia. Some of the sales resulted from orders sent by Texas Petroleum Company's New York City office to petitioner in Compton, California with directions that the order was to be shipped to Texas Petroleum Company in Colombia. Petitioner would then prepare documents showing petitioner as the shipper and Texas Petroleum Company, Colombian Division, as the consignee and purchaser.

Petitioner on its Federal income tax return for its fiscal year ended September 30, 1959, reported taxable income of $20,457.80.

Respondent in his notice of deficiency, in addition to making adjustments which, though originally placed in issue in the petition in this case, have now been disposed of by agreement of the parties, increased petitioner's reported income by an amount of $106,699.14 designated as "Sales increased" and made the following explanation of this adjustment:

> It is determined that commissions paid and discounts allowed to your controlled foreign subsidiary, Oil Base de Venezuela, C.A. were excessive in amount and had the effect of improperly shifting income from you to your controlled foreign subsidiary, thereby distorting your income and the income of your subsidiary. Furthermore, sales commissions were paid to Oil Base de Venezuela on certain sales occurring outside of Venezuela which were, in substance, your sales and on these sales no commissions are being allowed under this determination. In determining the proper amount allowable as commissions and discounts paid to Oil Base de Venezuela, C.A. where some amount is properly allowable, the determination has been based on arm's length negotiated rates between yourselves and uncontrolled parties on identical goods and services. This issue involves the application of sections 61 and 482 of the Internal Revenue Code of 1954. * * *

OPINION.

Petitioner recognizes that it and Oil Base, Venezuela, are organizations owned and controlled by the same interests within the meaning of section 482 of the Internal Revenue Code of 1954.[1] Petitioner contends that under that section respondent has erroneously used, in the reallocation of gross income deductions, credits, or allowances between petitioner and its subsidiary, a standard of arm's length bargaining. Petitioner points out that no such provision is contained in the statute and that although respondent's regulations[2] contain a state-

[1] All references are to the Internal Revenue Code of 1954 unless otherwise indicated.

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

[2] Sec. 1.482-1(b) [Income Tax Regs.] Scope and purpose. (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income,

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ment that the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer, no such standard has been applied by the courts.

Petitioner relies primarily upon *Frank v. International Canadian Corporation,* 308 F. 2d 520 (C.A. 9, 1962), and cases cited and discussed in that case.

Petitioner relies particularly on the following paragraph in *Frank v. International Canadian Corporation, supra:*

> For example, it was not any less proper for the district court to use here the "reasonable return" standard than it was for other courts to use "'full fair value,"[8] "fair price, including a reasonable profit,"[9] "method which seems not unreasonable,"[10] "fair consideration which reflects arm's length dealing,"[11] "fair and reasonable,"[12] "fair and reasonable" or "fair and fairly arrived at,"[13] or "judged as to fairness," [footnote omitted] all used in interpreting § 45 [of the Internal Revenue Code of 1939, the predecessor of Sec. 482].
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> [8]*The Friedlander Corp.*, 1955, 25 T.C. 70, 77.
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> [9]*Grenada Industries, Inc.*, 1951, 17 T.C. 231, 260, affirmed 5 Cir., 202 F. 2d 873, certiorari denied, 346 U.S. 819, 74 S. Ct. 32, 98 L. Ed. 345.
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> [10]*Motor Securities Co., Inc.*, 1952, 11 TCM 1074, 1082.
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> [11]*Palm Beach Aero Corp.*, 1952, 17 T.C. 1169, 1176.
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> [12]*Polak's Frutal Works, Inc., supra* [21 T.C. 953 (1954)] 21 T.C. at 975-976.
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> [13]*Seminole Flavor Co.*, 1945, 4 T.C. 1215, 1232.

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between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

It is petitioner's position that since it retained a slightly higher percentage of direct profit from export sales than from domestic sales even after allowance of commissions and discounts to its subsidiary in accordance with their contract, it has established, under the criteria of *Frank v. International Canadian Corporation, supra,* that it retained a reasonable return.

It is unnecessary for us to decide whether the sole standard in cases under section 482 is one of an amount which would be arrived at in arm's length transactions between unrelated parties. The commissioner has been given much latitude in his use of section 482 when necessary to prevent the evasion of Federal income tax by shifting of profits between taxpayers subject to common control. *Ballentine Motor Co.*, 39 T.C. 348, 357 (1962), affd. 321 F. 2d 796 (C.A. 4, 1963).

The burden is on petitioner to show error in respondent's allocation, and respondent's determination must be sustained unless it is unreasonable, arbitrary, or capricious. *Grenada Industries, Inc.*, 17 T.C. 231, 255 (1951), affd. 202 F. 2d 873 (C.A. 5, 1953), certiorari denied 346 U.S. 819. There is no evidence to show that the percentage return retained by petitioner on domestic sales would represent a reasonable return on its export sales. There is likewise no evidence to show that the amount of commissions and discounts paid to Oil Base, Venezuela, represented a reasonable amount, a fair amount, or an amount which would meet any of the other criteria referred to by the Court in *Frank v. International Canadian Corporation, supra.* Certainly the fact that these commissions are almost double those paid by petitioner to unrelated persons in arm's length transactions is evidence that they were not fair and reasonable.

Petitioner justifies the rates established for Oil Base, Venezuela, which were about twice the amounts it had been paying to Baritina and was currently paying to its representative in Canada, as well as about twice the amounts which its distributors, through classed as subagents of Oil Base, Venezuela, were charging in other countries, by stating that petitioner's board of directors considered a number of factors in arriving at the rates of commission and discount. The factors which petitioner stated were considered were that Baritina had represented to petitioner that it had just about been breaking even with respect to its representation of petitioner; that Oil Base, Venezuela, would be handling only petitioner's products whereas Baritina had handled noncompeting products of several other manufacturers and consequently had a broader base over which to spread its overhead costs; that Oil Base, Venezuela, would be starting from the very beginning whereas Baritina was an established and going concern; the manufacturing costs of the products involved which, of course, were known to petitioner as well as the selling price of the products; the high cost of operating in Venezuela and Colombia which was known to petitioner's management; and that it would be necessary for Oil Base, Venezuela, to obtain subagents and distributors in various foreign countries and to pay them commissions on sales made in those countries.

None of the alleged reasons justifies the rate of commissions and discounts allowed to Oil Base, Venezuela. Petitioner, in its proposed contract with Baritina had not increased the rate of commissions and discounts although it was insisting on minimum inventory to be maintained by Baritina, the building of a premix plant,

and the training of several sales engineers. It would, therefore, appear that if personnel of Baritina had represented to petitioner that Baritina had just about been breaking even with respect to representation of petitioner, petitioner was not impressed with this representation to the extent that it was considering the raising of commissions for Baritina or withdrawing from some of the additional demands it was making upon Baritina.

The second contention is likewise unimpressive. Oil Base, Venezuela, had only one full-time employee, who was the same person who as an employee of Baritina had devoted full time to petitioner's products. This arrangement was made prior to the incorporation of Oil Base, Venezuela. Petitioner does not explain why it considered a concern that was merely beginning in business to be entitled to a higher commission than a going concern with a number of employees. Petitioner has shown no reason why its knowledge of the gross profits from its sales should persuade it to allow commissions to its subsidiary about twice those it had previously paid, other than the inference that respondent would draw of shifting income to Oil Base, Venezuela. The high operating costs in Venezuela would not affect Oil Base, Venezuela, to an appreciable extent since its manner of operation had been set prior to its incorporation.

Petitioner's last point is not well taken since it has not shown why Oil Base, Venezuela, should have any appreciable profit on sales made by subagents in other foreign countries. All of the evidence of record in this case indicates that a fair and reasonable commission and discount to be allowed to Oil Base, Venezuela is the amount of commission and discount that had been

allowed to Baritina, was proposed in the new contract to be allowed to Baritina, and was allowed to petitioner's Canadian representative and various subagents with the exception of a lower commission being allowed to the Colombian representative for a short period of time. See *Jesse E. Hall, Sr.*, 32 T.C. 390 (1959), affd. 294 F. 2d 82 (C.A. 5, 1961). We sustain respondent with respect to his determination of the amount of commission properly allowable on sales in Venezuela.

The evidence clearly shows that petitioner needed sales representatives in Colombia and Mexico and that some commissions or discounts were necessary to obtain such representatives. Respondent's action in disallowing all commissions and discounts on such sales is unreasonable and arbitrary. During the time Baritina represented petitioner, that company handled petitioner's sales in Colombia through a subagent at the same commissions and discounts paid to it for sales in Venezuela. Petitioner has failed to show why commissions and discounts on sales in Colombia, Mexico, and Peru, if any, paid to Oil Base, Venezuela, should be different from those allowed to Oil Base, Venezuela, on sales in Venezuela. The agreements with the various subagents were for amounts of discounts and commissions identical to those paid by petitioner to Baritina and to its Canadian representative, and which respondent recognizes as proper to be allowed to Oil Base, Venezuela, on sales in Venezuela, except for a short period of the contract with Volco in Colombia. However, petitioner has shown no services performed by Oil Base, Venezuela, which would entitle it to a profit on these sales.

In this state of the record, we conclude that the same rates of commissions and discounts which respondent

has allowed to petitioner in computing its deductions with respect to sales in Venezuela are allowable to determine the proper deduction by petitioner with respect to sales in Colombia, Mexico, and Peru. We therefore hold that the rates of commissions allowed by respondent with respect to petitioner's Venezuelan sales are also proper with respect to all sales of petitioner's products in Colombia, Mexico, and Peru made through Oil Base, Venezuela, during the fiscal yaar ended September 30, 1959, in computing the amount of the commissions paid by petitioner to its subsidiary which is properly deductible by petitioner in determining its taxable income for its fiscal year 1959.[3]

Decision will be entered under Rule 50.

[3]Joint Exhibits 26-P and 27-Q, stipulated exhibits incorporated herein by reference, show the necessary information from which this computation may be made.